

Second Circuit's *Newman* Decision: Key Implications for the Defense Bar

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In a landmark ruling that will reshape insider trading defense strategy, on December 10, 2014, a three-judge panel of the Second Circuit Court of Appeals overturned two of the government's most prominent convictions – those against former hedge fund managers Anthony Chiasson and Todd Newman on charges they traded Dell Inc. and NVIDIA Corp. stock based on material non-public information. The Court held that the government failed to prove that the defendants, who were "remote tippees" – those who do not have direct contact with the original tipper but eventually come into possession of, and trade on, confidential information – knew whether the corporate insiders had received any tangible benefit in exchange for leaking confidential information.

The Second Circuit's decision is the second major loss in recent months for U.S. Attorney for the Southern District of Manhattan Preet Bharara and his famously aggressive string of prosecutions of insider trading. On July 8, 2014, a Manhattan federal jury acquitted Rengan Rajaratnam of conspiracy to commit securities fraud on charges that Mr. Rajaratnam traded on information given to him by his brother, Raj, who is currently serving an 11-year sentence for insider trading. Rajaratnam was acquitted after his jury was instructed that in order to return a guilty verdict, the jury had to be convinced that, as a remote tippee, Rajaratnam knew that the corporate insider had received a benefit in exchange for leaking the inside information.

At Chiasson and Newman's trial, the government presented evidence that a group of financial analysts received information from insiders at Dell and NVIDIA regarding earnings announcements. The analysts relayed the information to their portfolio managers, including Chiasson and Newman, who earned \$68 million and \$4 million, respectively, by trading on that information. The jury returned a verdict of guilty on all counts in December 2012. On appeal, the defendants argued that as remote tippees, they were too far removed to know that the company insiders were leaking confidential information in exchange for a personal benefit, as is required under *SEC v. Dirks*, 463 U.S. 646 (1983) and other case law.

Conceding that its jurisprudence has been "somewhat Delphic" regarding remote tippee liability, the Second Circuit's opinion sets out clearer rules on the matter, relying heavily on *Dirks*. In *Dirks*, the Supreme Court held that a corporate insider who leaked inside information solely for the purpose of

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uncovering fraud – but not for any personal benefit – did not breach a duty to his company and could accordingly not be liable for securities fraud

Referencing *Dirks*, the Second Circuit stated that first, “the tippee’s liability derives only from the tipper’s breach of a fiduciary duty, not from trading on material, non-public information.” Second, “the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure.” Third, “even in the presence of a tipper’s breach, a tippee is liable only if he knows or should have known of the breach.” *Scienter* is a “necessary element in every crime” and is “particularly appropriate in insider trading cases,” the Court emphasized.

The ruling will reshape insider trading law in a few key ways.

First, the decision will impose a new evidentiary burden on prosecutors in proving scienter, the tippee’s knowledge that there was a breach by the corporate insider. The Court took aim at the “doctrinal novelty of [the government’s] recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders.” Chiasson and Newman were three to four degrees removed from the original tippers, and accordingly, the government could not prove that they met the requisite scienter requirements. Indeed, Bharara’s conviction of Michael Steinberg – a former SAC Capital Adviser LP portfolio manager sentenced to prison in May 2014 for insider trading – is now at risk. Steinberg has argued on appeal, like Chiasson and Newman, that he was too far removed from the original breach of fiduciary duty by the corporate insider to know what personal benefit the tippers gained. Prosecutors will therefore be forced to reassess how far removed from a tipper they can reach while still proving scienter.

Second, the Second Circuit substantially narrowed what constitutes a “personal benefit.” Previously, the government argued that nebulous gains like possible reputational improvement could constitute a personal benefit. In *Newman*, however, the court held that there must be a tangible “quid pro quo” and a “potential gain of a pecuniary or similarly valuable nature.” Simply encouraging a “casual acquaintance,” for example, will no longer suffice.

Third, although *Newman* is a criminal case, its holdings should apply to SEC actions as it relies so heavily on *SEC v. Dirks*, a civil enforcement action. Because it is only allowed to bring civil actions, the SEC has a lower burden of proof than the Department of Justice has in criminal trials. Accordingly, the agency may attempt to continue to bring actions against far-removed tippees in the wake of *Newman*. Such efforts may include bringing more insider trading cases “in-house” before administrative law judges, as SEC officials have recently signaled. Defendants in those actions, however, should argue that the higher



burdens on prosecutors – specifically, clearly proving the tippee's knowledge of the tipper's personal benefit (as narrowly described by the Second Circuit) – also fall on the SEC.

Finally, a note of caution. With the higher evidentiary burden that it must now satisfy, the government will likely increasingly seek to introduce direct evidence such as wiretaps and other surveillance methods, instead of the circumstantial evidence that has often been used to secure convictions in the past.

Newman is the most important insider trading ruling in recent years. It arms remote tippees with a greater ability to argue that they did not know what personal benefit the original insider gained by leaking confidential information. As a result, it significantly shrinks the radius of defendants who could be held criminally or civilly liable for insider trading.

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